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Economic Conditions
Governmental Finance
United States Securities

New York, October, 1945

General Business Conditions

THE opinion expressed in the last issue of this Letter — that the physical difficulties of reconversion would prove to be minor and temporary, while wage and price problems would emerge as the major concern of the period — has been confirmed in both respects by the business news of the past month. Necessarily industrial activity has declined sharply as war work ended, and probably more time must elapse before rising civilian production can halt the recession. But there have been differing views as to whether readjustment would be long or short and reconversion a "great emergency" or a reasonably smooth and rapid process. Major decisions of public policy depend upon these points. Amid the harassments of labor disturbances and labor shortages, and uncertainties as to costs and prices, the heartening fact which now appears is that the factory changeover part of the job, from engineering and design to plant clearance and retooling, is being carried through more quickly and smoothly than most people believed possible.

Durable consumers' goods are beginning to come from the factories and most of the automobile companies will start up assembly lines in October. The War Production Board has made a survey of 3,750 manufacturers in the durable goods industries which now face reconversion, and the reports indicate that by December the production of these companies will be 12 per cent higher than the 1939-41 average, while by June 1946 it will be 87 per cent higher. The general manager of the Automobile Manufacturers Association has stated that, if labor disturbances do not interfere, the automobile factories can get back to prewar production by next February and to a rate of 6,000,000 cars annually by June.

Evidence of the readiness of these industries to go ahead is seen in the steel business. New orders for steel for civilian use have been heavy, outrunning production in many products, and despite cancelled war orders mill books for the fourth quarter are crowded. Production of steel ingots dropped for one week to 65 per cent of capacity, but has recovered rapidly to 84 per cent and would be higher if the mills could get more workers.

Unemployment Overestimated

It is also seen that the pessimistic predictions of eight to ten million unemployed "within six or eight weeks after V-J day" enormously overshot the mark, for as of the first week of September the Census Bureau estimated total unemployment at 1,700,000. This was an increase of 900,000 in four weeks, virtually all since V-J day. Now the first rush of layoffs from war work is over, and since early September the rate of increase in unemployment has almost certainly slackened.

The outstanding subject of comment is not the unemployment, but the shortage of workers, in the textile factories and steel mills, the mines and lumber camps, and in various other industries as well as in the trades and services. Thus the question to which attention should be given is, what prevents employers from obtaining help while workers at the same time are out of jobs, and thus causes the anomaly of unemployment concurrent with substantial labor shortage, frequently in the same territory or community? The New York State Commerce Commissioner recently reported that more than 200,000 jobs were available in the State, although at the time 175,000 persons were on the unemployment compensation rolls.

It is never to be expected that the jobs available and the people seeking jobs will exactly match as to qualifications, location, etc., but there are more reasons than that for the present unemployment. One reason is that many war workers do not want any job at all until they have had a rest and vacation, which is wholly natural. Unemployment of that kind is the concern only of the workers themselves. Another reason is that many do not want to take reductions from their war wages in changing to peacetime jobs. A third is that many prefer to live for a time on unemploy-

ment compensation if the alternative is working for about the same amount. Without arguing public and union policies at this point, it seems correct to say that the country is not likely to view the unemployment with much sense of crisis as long as it is more voluntary than involuntary, and while jobs are widely available. The House Ways and Means Committee took that view in refusing to report out the bill proposing extension of unemployment compensation by federal funds.

Like the employment statistics, trade reports show that the situation is better than the pessimists feared. During the past month department store sales, which had slackened in August, have made substantial gains over both the previous month and a year ago.

Reliance on Business Initiative Justified

The promised speed in reconversion exceeds expectations held before V-J day, and certainly the facts thus far cited are at variance with the predictions of a "great emergency". To be sure, the bulk of the demobilization of the armed forces lies ahead. Also, there is no certainty that manufacturers' intentions to expand peacetime production on the scale reported will all be realized, for the conditions which govern are not wholly under their control. They have to contend in too many cases with labor disturbances and shutdowns, either in their own plants or in those of their suppliers. They are handicapped in other cases by labor shortages, or by not knowing yet whether the Office of Price Administration will allow them to put profitable prices on their products. They face the further uncertainties as to costs, prices and production levels, which go along with union demands for large and general wage increases. What the effect of these dangers may be in impeding reconversion and slowing down the recovery in civilian production is for the next two months to show.

The evidence does establish, however, that business men are optimistic and ambitious, and that they are moving with energy and resourcefulness, depending upon their own ingenuity and under no stimulus or compulsion except their own desire to do business. Moreover, they have programs of plant improvement and expansion on a scale which may rival the most active periods of the past, if construction costs are not prohibitive. On all sides are signs that the spirit of enterprise is high, and that the reliance which Mr. Snyder and Mr. Krug have placed on the initiative and ingenuity of business to carry out reconversion swiftly is being justified.

The question now is whether the conditions established by other government policies, and even more by labor union policies, will be such as to make the most of the abilities inherent in free business planning and free enterprise. Or will initiative be discouraged, resourcefulness blocked, and reconversion impeded?

The Union Demands

The demands of the unions for a 30 per cent increase in hourly wage rates, backed by threats of strikes, are based upon three principal arguments. One is that the decline in take-home pay, which follows the ending of high-paid war jobs and elimination of overtime work, has to be made good through increased hourly rates if workers' buying power and markets for the industrial output are to be preserved. Another is that the Little Steel formula has depressed the real wage of labor by ignoring the rise in the cost of living above that recognized in the formula; and that with the war over this injustice should be rectified. The third is that the distribution of wartime earnings between employers and workers has been inequitable, resulting in exorbitant corporate profits. The third argument is examined on a subsequent page of this Letter.

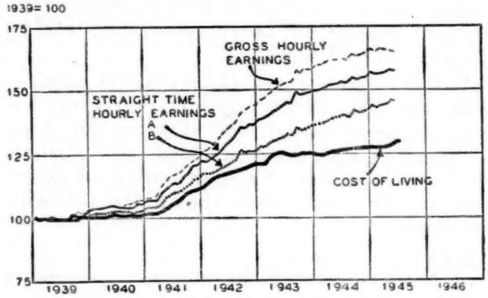
Wage arguments are always difficult, for misunderstandings, prejudices and misrepresentations abound. Employers do not question that the take-home pay will decline if hourly rates are unchanged, and there is much sentiment for whatever advance in straight-time rates can be justified by increases in man-hour output. Employers, however, are at the mercy of those who buy their goods. They have to consider not only wage rates but the productivity of the worker, the level of wage costs and overall costs, and the effect of cost increases upon prices and ability to sell the product.

The claim that take-home pay must be maintained if the products of the industries are to be absorbed overlooks two facts. One is that union workers themselves buy only a part of what they produce. The rest is purchased by farmers, unorganized workers, professional people, the white collar class, pensioners and others living on fixed incomes, — many of whom, incidentally, have had much smaller pay increases during the war than factory workers. The second fact is that wages are a part of costs. If the effect of wage increases to industrial workers is to raise prices beyond the power of other groups to pay, the product of the industries cannot be absorbed, and the workers will give up in unemployment what they think they have gained in money wages. On the other hand, if all wages are raised prices will follow and no one will gain relatively.

The Cost of Living

The argument that wage rates have lagged in comparison with the cost of living is seen to be incorrect if the data of the U. S. Bureau of Labor Statistics are accepted as authoritative. We show herewith a chart which com-

pares the official cost of living index with three measures of hourly earnings in the manufacturing industries. The topmost line is a simple division of total earnings by hours worked. Line A excludes the effect of premium pay for work above 40 hours. Line B further eliminates the effect of wartime shifts from lower-wage to higher-wage industries by calculating straight-time hourly earnings according to the distribution of employment in January 1939. Line B may be considered most representative of the level of wage rates to prevail in the postwar period. It has gained more on the cost of living since the Little Steel formula was adopted in July 1942 than before that time.



Hourly Earnings in All Manufacturing Industries and Cost of Living

Straight time hourly earnings (A) are calculated to exclude premium pay at time and a half for work in excess of 40 hours; extra pay for work on supplementary shifts and on holidays is included. Straight time hourly earnings (B) eliminates interindustry shifts by weighting the straight time hourly earnings by January, 1939 employment; extra pay for work on supplementary shifts and on holidays is included.

Source: U. S. Bureau of Labor Statistics.

In the official cost of living index the products of agriculture have a weight of 34 per cent. The U. S. Dept. of Agriculture and many other authorities believe that prices of farm products are more likely to decline than to advance, after present abnormal demands subside. Thus there is high promise of stability in the cost of living index, — unless the labor unions themselves force up the prices of the manufactured goods which make up most of the remainder of the index. If farm prices decline and prices of manufactured goods advance, farmers will not long be able to buy full quantities of industrial products.

The Inflationary Danger

The present situation is extraordinary in that prices are controlled. If wage increases squeeze the margin between costs and the controlled prices the incentive and ability to produce will be curtailed, and higher-cost producers will be compelled to work at a loss or cease operations, diminishing the supply of goods at a time when the urgent need is greater production. But if ceilings are broken and prices pushed up, the danger is of an inflationary spiral, fed by excess money supplies and by speculation, inventory accumulation and hoarding, until the structure collapses through fundamental weaknesses and excesses as in 1937, 1929, 1921 and other past periods.

Interruptions of production by strikes likewise feed inflation. For they diminish the supply of goods at a time when it is insufficient relative to money buying power and when the main hope of maintaining stable and orderly markets is to increase the supply. The way out of inflation through increasing supplies has been demonstrated since V-J day, by the appearance of more foods in the markets and the resulting easing of strain, correction of maldistribution and curbing of black markets. It is now seen that these results are acomplished easily and automatically by making more goods available; and, despite all efforts of the overhead control, probably they could be accomplished in no other way.

Arguments in detail as to whether industry can afford this or that percentage wage rate increase tend to obscure principles. The main principle in which the public interest is centered is that wage increases should not be granted which will raise prices, which will start an inflationary boom or multiply the inflationary danger, or which will eliminate or so greatly reduce profit margins as to impair production. This leaves the way open for increases that are justified by harder, more efficient, and more devoted work, and therefore by higher productivity. This is the way in which all past progress in raising living standards has been made. If increases should be granted in advance of the showing of productivity, and the latter should not develop, the economic outlook would be perilous indeed. The danger might be obscured by inflation and an appearance of good times, but the appearance would be an illusion.

In many of its elements the economic situation reveals a general weakness, namely, the unwillingness of people to reconvert their attitudes from those accepted during the war to those needed now during peace. It is already seen that physical reconversion will be no vast or long-drawn problem. But reconversion is more than a physical process. It requires new attitudes, and above all acceptance of the fact that production, prices and in last analysis wages must now conform to what a multitude of consumers want and can pay, instead of to the orders of one customer whose needs are insatiable and interest in prices secondary. Much civilian work, necessary to full employment, cannot pay war wages, and much cannot pay the 65 cent minimum wage which the labor unions are now demanding. To establish such a minimum by statute would condemn many people to unemployment. Meanwhile

some proportion of present unemployment exists, in all likelihood, because unemployment compensation is more attractive than work.

These attitudes are the exact opposite of what the present situation needs. They are obstacles to production, they block reconversion, they impede the supplying of civilian wants, and they foster inflation. They establish danger of a wholly unnecessary and man-made emergency, at a time when business is demonstrating its energy and resourcefulness, and when all-around cooperation and steady efficient work would offer unlimited promise of a sound and lasting prosperity.

Industrial Wages and Profits

In the recent demands by labor organizations for a 30 per cent increase in basic wage rates in the automobile, steel and other industries, great stress has been laid upon the increase in corporate profits during the war period. It is claimed that the companies now have undistributed earnings and reserves, represented by liquid resources, ample to stand the higher wages. It is argued also that there will be a high level of production and trade after the war, and it is necessary that labor receive high wages in order to be able to buy the goods produced.

A brief review of the facts in the cases of General Motors Corporation and the major steel companies will show the trend of wartime earnings, wages and other financial changes in the automobile and steel industries, which are typical also of the trends in numerous other lines.

General Motors Corporation

The demand of the United Automobile Workers of America — C.I.O. on the General Motors Corporation for a 30 per cent wage increase is contained in a letter from Walter P. Reuther, vice president of the U.A.W. to C. E. Wilson, president of General Motors. On the subject of profits and wages the letter states:

> The General Motors Corporation will have no financial difficulty in meeting the demands contained in this letter.
>
> This corporation has been described by the Federal Trade Commission as the most profitable corporation in the history of the world. It has done very well for itself since it has had Uncle Sam as its principal customer. With the slogan, "Victory Is Our Business," GM's profits in 1944 before taxes were $435,409,024. That is **seventy-eight per cent** more than the yearly average profits of $244,779,268 for 1936 through 1939.
>
> Its total wage bill in 1944 was $995,094,170. GM could have paid $1,085,723,926 in wages in 1944, or **$190,629,756 more than it did pay.** All of this increase would have come out of the EXTRA profits it was making **because of the war!**
>
> Between 1939 and 1944 the Corporation's **net worth increased twenty-two per cent,** to the staggering sum of $1,304,071,620. In addition to increasing its net worth the Corporation distributed $630,565,644 in dividends on its common stock and $45,891,000 in dividends on preferred.

In the earnings figures presented it would seem, from an examination of the Corporation's annual reports, that the increase in earnings before taxes has been *understated,* — a mistake not often made by the C.I.O. The 1936-39 average was not $244,779,268, but $221,491,634, so that the increase was not 78 per cent, but 97 per cent. Income after taxes, however, was 5 per cent smaller. The figures on wages cover only the hourly-rate employes in the United States, comprising 72 per cent of the total number of employes. The statement does not compare dividend payments in 1944 with the annual average 1936-39, but uses a cumulative total for the five years 1940-44.

If the original comparison of 1944 earnings with the 1936-39 average, as corrected, had been carried through for other major items of receipts and disbursements, the changes that took place in the distribution of corporate income would have shown the following pattern:

Net receipts from sales $1,372 million to $4,262 million	+211%
Average number of employes 225,505 to 465,617	+106%
Total payroll $383 million to $1,380 million	+260%
Average annual compensation per employe $1,692 to $2,964	+ 75%
Average hourly earnings in automobile industry (U. S. Bureau of Labor Stat.) 88.0c to $1.27	+ 44%
Federal and foreign income and excess profits taxes $41 million to $264 million	+539%
Net income (after deduction of costs for goods and all other expenses; provision for depreciation and amortization of real estate, plants and equipment; and reserves for taxes, but including income from investments as well as from operations) $180 million to $171 million	— 5%
Net income per dollar of sales 13.1 cents to 4.0 cents	— 69%
Rate of return on net worth 18.0 per cent to 13.5 per cent	— 27%
Dividends paid to preferred and common shareholders $151 million to $141 million	— 7%
Dividend per common share $3.30 to $3.00	— 9%

The aggregate of $676 million cited in the above quotation as dividends paid during the five years 1940-44, is, truly, a large figure, but General Motors Corporation is the largest industrial organization in the world. Its capital is supplied by approximately 424,000 individual and institutional shareholders, a total only moderately less than the number of em-

ployes. Average dividend paid last year to shareholders (including financial and other institutions holding comparatively large blocks as investment for their own account or in trust for large numbers of beneficial owners) was but $333.

Against the aggregate of $676 million paid in dividends in the five years 1940-44, the Corporation paid in wages and salaries $4,723 million, or seven times as much, and in 1944 payrolls were almost ten times dividends.

Steel Wages and Profits

The United Steelworkers of America — C.I.O. backed up their demands last month for a general increase in wage rates with the claim that profits in the industry after taxes rose 113 per cent in the five-year period of 1940-44 above those of 1935-39. Comparative figures also on dividends, reserves and other items are given in a pamphlet containing an introductory statement by Philip Murray, president of the Steelworkers Union and of the C.I.O., from which we quote in part:

> Never before have the steel companies been so rich. For five years of war production the steel industry has charged the American people over two billion dollars in open and concealed profits.
>
> Contrast this with the financial position of America's 475,000 steelworkers. In five years of war work they have accumulated only a total of $285 million in savings or $600 a worker.
>
> This inequitable distribution of the industry's earnings is not only an injustice to steelworkers; it is a threat to the postwar prosperity and security of America because the bulk of the nation's savings is not in the hands of the people who do the bulk of the consuming.
>
> Hence the immediate need for substantial wage rate increases to enable workers (1) to meet the increasing burdens of higher living costs and (2) to assure a high level of purchasing power for the maintenance of full production and full employment in an expanding postwar economy.

The study is based upon a tabulation of the published annual reports of 18 steel companies, representing about 89 per cent of the industry's ingot capacity, from which estimates are projected for the entire industry. The increase cited in net income tends to give a much more favorable impression of earnings than if considered in relation to the industry's volume of sales, payrolls, and capital investment, not shown in the pamphlet.

Steel capital and labor were the backbone of the country's tremendous program of war material production, which within a comparatively short period of time outstripped the rest of the world combined. Sales of steel products are the basic source of funds available for payment of wages, purchases of raw materials, taxes and dividends, as well as for repairs, maintenance and improvements to the property. Changes in sales and other items from the five-year period 1935-39 to 1940-44 compare as follows with net income and dividends:

Estimated net sales* $11,869 million to $29,328 million	+147%
Average number of employes† 595,000 to 871,000	+ 46%
Five-year total of payrolls† $4,418 million to $10,330 million	+135%
Average annual compensation per employe† $1,485 to $2,372	+ 60%
Average hourly earnings in steel industry (U. S. Bureau of Labor Stat.) 76.7c to $1.025	+ 34%
Total taxes† $589 million to $2,774 million	+371%
Net income after taxes $576 million to $1,225 million	+113%
Dividends paid to preferred and common shareholders $419 million to $765 million	+ 82%

*Estimate based upon reports of the same 18 leading companies, excluding Midvale Company, a subsidiary of Baldwin Locomotive Works, for which separate sales figures were not published. Sales include receipts of coal mining, railroad, shipbuilding, and other subsidiaries, but are net of renegotiation refunds, if any. †Based upon figures compiled by American Iron & Steel Institute.

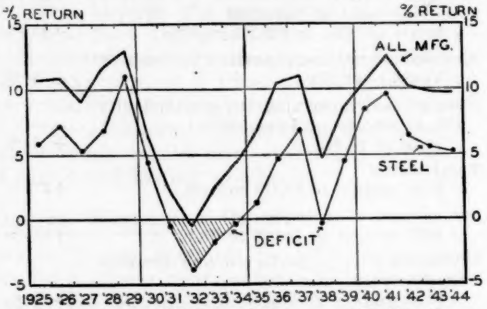
The sharp percentage increase in net income resulted from the unprecedented expansion in the production of steel to meet wartime demands, and of substantial increases in plant capacity. Net income in the steel industry is a traditionally narrow "residual" item, subject to sharp fluctuation either up or down. Average net profit margin actually declined, from 4.9 cents per dollar of sales to 4.2 cents.

1935-39 a Period of Low Earnings

Moreover, the comparison of dollar net income was made with a base period in which return on capital was at a depressed level, including one year when a majority of steel companies operated at net deficits. The steel industry is one requiring heavy capital investment in blast furnaces, rolling mills and other machinery, averaging $6,300 per employe, without which the individual steelworker could produce little. Rate of return on net worth of leading steel companies, according to our own annual tabulations of published statements as summarized in the April issues of the Bank Letter for a number of years, averaged 7.1 per cent for the five-year period 1940-44, which was more than double the average of 3.4 per cent for 1935-39, but slightly below the 7.3 per cent for 1925-29.

Steel wage rates, in contrast with corporate profits, were not depressed in the period 1935-39, the average hourly earnings of 76.7c being in fact 19 per cent higher than the 1925-29 average. Moreover, while the 1940-44 average was $1.025, the rate was rising steadily during the period, and the 1944 average was $1.167.

In each of the twenty years 1925-44, rate of return of the steel group was, as shown by the accompanying chart, below that of all manufacturing companies. For 1940-44 the average of 7.1 per cent for steel compares with 10.5 per cent for all manufacturing companies.



Average Annual Rate of Return on Net Worth of Leading Companies in the Steel Industry, and in the Manufacturing Industries Generally.

In each year since 1941, when this country entered the war, the trend of steel earnings and dividends paid has been downward. Whereas in the five-year period 1935-39 the industry's payroll was about 10½ times the dividends, in 1940-44 payrolls were 13½ times dividends. Yet the C.I.O. speaks of "the astounding extent to which the *industry* and the *stockholders* have prospered as a consequence of World War II" (italics ours).

The Question of "Concealed Profits"

Mr. Murray states that "For five years of war production the steel industry has charged the American people over two billion dollars in open and concealed profits". This is some $800 million above the five-year total of $1,200 million net income given above, which represents net earnings on sales and on capital investment, and not "profits" in the sense of speculative or fortuitous gains.

This claim of $800 million in "concealed profits" is based upon the assertion that various charges for "reserves" on the steel companies' statements were excessive and therefore not proper deductions from income in computing net earnings. The C.I.O. study cites: (1) Reserves (apparently referring to general or contingency reserves not designated for specific purposes); (2) Reserves for amortization of emergency plant facilities, which under the revenue law are deductible for tax purposes at a faster rate than reserves for depreciation of ordinary plant and equipment, and which are assumed to be twice as high as necessary; (3) Excessive reserves for depreciation and depletion, to the extent that they exceeded those of the year 1937; and (4) Excessive reserves for pension payments and/or incentive compensation trusts, to the extent that they exceeded 1937. It is said:

These four forms of hidden profits amounted to $217 million in 1944. A study published by the United Steelworkers of America last year showed that these hidden profits amounted to over $250 million in 1943. But to be conservative, it is assumed that the hidden profits for the five war years were only $800 million (although they probably amounted to over one billion dollars).

Executives of leading steel companies have pointed out that Mr. Murray previously made a similar statement which was answered in the findings of the War Labor Board released in September 1944. At that time the Steel Panel found that the cost items, termed by the Union to be hidden profits, "are proper and cannot be considered as concealed profits."

Financial statements of the large steel companies are prepared by certified public accounting firms of recognized standing, and are subject to audit not only by the Bureau of Internal Revenue but also by other government departments such as Army, Navy, O.P.A., S.E.C., etc. While in some cases the exact amounts of reserves set up for various purposes are necessarily based upon estimates, it would be unreasonable to deny that, in view of the record-high rate of iron and steel production during the war years, higher reserves are warranted for wear and tear on plant and equipment, including special facilities built for war products, and for exhaustion of mineral resources, as well as for pensions covering a greatly enlarged labor force. Increased depreciation of equipment and depletion of mines and quarries are just as much a part of the wartime cost of doing business as increased cash outlays for labor and for purchase of materials. Expenses of converting factories back to the production of peacetime goods are, likewise, as much a part of wartime costs as the expenses of bringing American soldiers back home following the end of hostilities.

The Real Test of Wage Rates

The foregoing figures show, first of all, that in the distribution of corporate income during the war years the employes have benefited immensely, through the sharp increase in wage rates as well as the expansion in employment. Despite the largest volume of business in history, corporate margins of net profit on sales have been narrowed. Net income after taxes in the case of General Motors has declined, and in the case of the steel companies has risen from a depressed level and then turned downward. Steeply increased taxes have absorbed most if not all of the increase in operating earnings.

The more fundamental issue, however, is not the retrospective argument over the distribution of corporate income during wartime, but the proposition that the wartime levels of corporate income should now become the basis

for establishing permanently higher peacetime wage rates. Corporate earnings are subject to wide fluctuations, while wage rates, once established, can seldom be reduced and are more often increased. Proposals that corporate surpluses and reserves should be used for payment of higher wages disregard both the fact that they are needed in the business, and that they would not last long if so paid out.

Undistributed earnings and reserves — not only in automobiles and steel, but in most lines of industry — will be required and are already being used for reconversion expense and deferred maintenance, and for financing modernization and postwar growth. Many thousands of companies producing war materials expanded their volume of business several-fold. Today they face a difficult and costly curtailment of their organizations. In many cases accumulated earnings will be absorbed or largely reduced in the fight for survival. Industrial companies will need to make extensive expenditures on plant and equipment, and upon the development of new products, if they are again to meet active competition and continue to give employment.

Corporate earnings and reserves, if represented in the form of working capital and paid out in higher wages, would in most cases last for no more than a few weeks at best. After they had become exhausted, industry would be deprived of the funds that otherwise would have been used in furthering production and employment, and the workers would have had a temporary benefit, but a permanent loss. The well from which labor had drawn its wage bonus would have run dry. In last analysis current wages must come out of the revenue currently received from the sale of goods.

The test of sound wage rates is whether they promote the greatest possible sale of goods and hence the maximum of production, employment and real wages.

"A Tax Program for a Solvent America"

As the Congress is about to consider an interim tax bill for the transition period, there has become available under the above title the most recent of a series of studies by private groups dealing with the problem of postwar taxes. This latest study is the work of the Committee on Postwar Tax Policy, composed of leading fiscal authorities under the chairmanship of Roswell Magill, former Undersecretary of the Treasury, and financed by a special grant from the Maurice and Laura Falk Foundation. Consisting of a 275-page report,* prepared following a 16-month study by the committee, "A Tax Program for a Solvent America" presents an authoritative, comprehensive survey of the tax question and its relation to fiscal policy that is most timely and merits careful study by the Congress, the Treasury, business groups, and all others seeking answers in this controversial field.

What the committee means by a "solvent America" is stated as follows:

> **Our interest is in a tax program for a solvent America. By national solvency we mean that the government can and does live within the fiscal resources which are provided for it by the people through taxation. In a fundamental sense a government is insolvent if it regularly and habitually provides public benefits in excess of the amounts which the people are able — and willing — to pay in taxes. Such a course leads eventually to insolvency in the very real sense of inability to pay just debts when due.**

In these words, and elsewhere through the report, the committee repudiates deficit spending as an instrument of fiscal policy. It believes that the goal of active useful employment and production and of high living standards can be reached by the sound and time-tested method of the encouragement and re-energizing of private enterprise, the essence of which is "the freedom of the individual to engage in business, risking his capital in the competitive market in the hope of obtaining a profit commensurate with the risk involved."

"Capital," declares the committee, "is the fountainhead of jobs in our capitalistic system," and "those who supply capital are, thus, the real creators of jobs." But "continued prosperity can be achieved only if government policies encourage the investment of private capital, and through that the release of the creative energy of the individual." The report enumerates various ways in which government policy can stand in the way of such investment: excessive and prolonged emphasis on reform at a time when considerations of recovery should be paramount; over-regulation of business, industry, and markets; activities calculated to bring the government into competition with private enterprise; unsound fiscal policies. "Taxation," the report asserts, "cannot create the spirit of enterprise, but when badly devised and imposed at heavy rates, it can limit or destroy it."

Thus, the committee concludes, "a sound peacetime fiscal program must address itself, on the one hand, to assuring the investor a fair return on his capital after payment of his taxes, and on the other, to reducing or elimi-

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******A Tax Program for a Solvent America***: The Ronald Press New York, 1945. Members of the committee, in addition to Mr. Magill, chairman, were: Fred R. Fairchild, Knox Professor of Economics, Yale University; Rowland R. Hughes, Comptroller, National City Bank of New York; Victor H Stempf, President, American Institute of Accountants; and Thomas N. Tarleau, Member of New York Bar, and former Tax Legislative Counsel of the Treasury. Harley L. Lutz, Professor of Public Finance, Princeton University, served as director of research, and Alfred Parker as associate director.**

nating that particular threat to confidence, and hence to investment, which stems from unsound government financial policy."

Would Lower Individual Income Taxes

The committee's specific tax proposals are made with these considerations in mind. The program embodies a well balanced division between corporate and individual taxes, with the ultimate goal the same starting rate of tax for both in order to avoid discrimination against any form of economic effort, and in the meantime a practical plan for working towards that goal. The recommendations deal with a "transition period," estimated at two to three years, and with the "normal, long-range postwar period" which will follow.

For the transition period, the committee recommends as an immediate step to relieve individual tax burdens the repeal of the 3 per cent normal tax. This would free approximately 9,000,000 people, principally in the low income brackets, from paying any federal income taxes. As a companion move, the committee calls for some immediate readjustment in the extreme wartime surtax scale, now beginning at 20 per cent on the first $2,000 of surtax net income, rising to 50 per cent of the taxable income between $16,000 and $18,000, and continuing to 91 per cent of income in excess of $200,000. Conceding that severity of rates is defensible under war conditions, the committee finds the present scale wholly incompatible with the normal peace situation, and warns that with the passing of the war emergency and war danger the tax rates must be readjusted in recognition of the fact that there is little incentive to productive effort if two-thirds or three-fourths of everything earned goes to the Treasury in taxes.

Later, if and when fiscal requirements can be brought down to more moderate levels, individual taxes should be further reduced. The committee proposes an initial rate between 15 and 20 per cent, depending on the level of expenditures, with the scale ranging progressively upwards to 25-30 per cent at the $8,000-$10,000 bracket, 40-45 per cent at the $25,000-$50,000 bracket, and 49-54 per cent at the $75,000-$100,000 bracket, with a top rate of 67-72 per cent at the $1,000,000 level.

The committee would keep the present exemption of $500 for each taxpayer and for each dependent, alleviate the present double taxation of dividends paid to individuals by allowing a credit to stockholders receiving the dividends, and retain the withholding principle and current payment of taxes. Married persons would continue to have the option of making joint or separate returns. There would be no change in the tax treatment of capital gains for at least five years.

Repeal Excess Profits Tax

The committee joins with most other authorities in recommending immediate repeal of the corporate excess profits tax now that the war is over. Such a tax, it insists, has no place in a peace economy, for it tends to nullify the whole function of profits in the private enterprise system and would fall with particular severity on new and growing concerns. Retention of the carry-back of unused excess profits credits is urged for the two-year period now provided or for as much thereof as may be necessary to assure recognition of all deferred war costs in the determination of true excess profits.

Both the capital stock tax and the declared value excess profits tax would be done away with during the transition period, and a gradual reduction started of the corporate normal and surtax, with the application of a lower rate on small corporations.

For the longer range, a program of simplification is recommended in connection with corporate taxes. The surtax would be eliminated and a single tax imposed, with the ultimate objective of bringing this down to the same, or approximately the same, rate as the initial rate on individual income. This, the committee feels, would promote employment and production by tending to equalize the tax burden on all types of income.

Repeal of the excess profits tax would leave the corporate rate at its present level of 40 per cent. The committee believes that this rate could stand for the first transition year, provided there were assurances that it later would be reduced, perhaps to 35 or 33⅓ per cent in the second transition year and eventually to a level equal or close to the initial individual rate.

Further to alleviate double taxation of dividends, the committee would remove the tax on intercorporate dividends, and repeal the penalty tax on consolidated returns. Greater recognition, it is stated, should be accorded to business accounting procedures and results, with particular reference to depreciaton and depletion, expenditures for research and development, and salary determination.

While most of the wartime "nuisance" taxes would be removed, a reasonable number of excise taxes would be retained after the war, their scope depending on the level of expenditures and revenue needs. These taxes the committee views as desirable to diversify the sources of revenue and to stabilize the tax yield in times of financial strain. The committee does not definitely recommend a federal sales tax, but points out that such a tax may be necessary if the budget reaches high levels

Taxation of estates, gifts, and gasoline, would be left to the 48 states in the interest

of preserving the financial independence of the states in the performance of state and local functions.

Expenditures the Key

In presenting its recommendations for tax reductions, the report stresses the dependence of ability to carry them out upon how much federal spending is reduced and how soon. "If a policy of free spending is followed, very few choices among taxes will be possible. The Treasury will have to seek all the revenue it can get from all the sources available to it."

The report presents three sample budgets after the war — $15 billion, $18 billion, and $22 billion — not as predictions but only as examples to show what can be done with taxes at these various budget levels. The report then considers these budgets in connection with various assumed levels of postwar national income — $115 billion, $125 billion, and $140 billion. Accepting the figure of $125 billion as representing a conservative projection, the report demonstrates by a series of tables what successively higher budgets would mean in cramping the possibilities for tax reduction and limiting flexibility in the choice of taxes in the effort to avoid harmful effects upon enterprise. The showing raises grave doubts as to the consequences of a tax burden resulting from spending $25 billion a year, a figure now heard with increasing frequency and seemingly gaining acceptance by mere force of repetition without adequate consideration of why it is necessary to spend that much or what the effects would be upon the fiscal situation and the economy in general.

The committee acknowledges that the projected total of $125 billion for postwar national income may prove to be too low, and that budget difficulties would be easier of solution at a $140 billion level of national income. It cautions, however, against erecting budgetary assumptions and revenue estimates on the basis of figures that may prove over-optimistic, and emphatically rejects the device of attempting to inflate the national income by deficit financing, observing:

> **Under such circumstances the volume as well as the character of the taxation imposed would be of minor consequence. The burdens and economic penalties of such a policy would find expression in a different channel. That there would be burdens and economic penalties is not open to question.**

Revenue Stability Emphasized

One of the most important points revealed by the study is the necessity, as the budget rises, of evolving a revenue system which will have a reasonable degree of stability under varying economic conditions. With our revenue system heavily dependent before the war upon business profits and the personal incomes of a small segment of the population, the flow of receipts tended to dry up rapidly with any substantial fall in the level of business — a development which will prove much more serious in the future at the greatly expanded level of national debt and current government expenditure. This means that, whether we like it or not, we need to seek a more broadly based as well as more diversified tax system, reaching both a larger number of income taxpayers and relying to a larger extent than in the past upon consumption taxes which fluctuate relatively little.

The report contrasts the budgetary record of this country and that of England in the 1929-32 depression in support of this point. Whereas the extent of the depression in the two countries, in terms of national income, did not differ greatly, this country, relying almost entirely on a narrow income tax base, saw its revenue receipts drop 47 per cent, while England had revenue receipts actually 2 per cent higher in 1932 than in 1929. As the report points out, England relies to a larger extent than we do upon customs and excise taxes, and upon the individual normal tax rather than surtax.

In other words, the higher our budget, the larger the number of people who in one way or another will find themselves footing the bill.

Still another significant feature revealed by the study is the variety of sources from which venture capital is drawn. Data presented show that it comes from individual investors all up and down the income scale, with small investors surprisingly important. While the reinvestment of earnings by corporations always has been recognized as an important source of venture capital and of funds for the creation of jobs, the report emphasizes also the importance of unincorporated business in this field. The net income of sole proprietorships and partnerships (a mixture of wages and profits) has averaged more than half as much as corporation net income since 1924.

This large proportion of business earnings that comes under unincorporated business, subject to individual income taxes, is important in connection with the problem of stimulating venture capital, and explains the committee's concern in working ultimately towards a tax structure in which the corporation tax rate approximates the initial rate on individual incomes. When the corporation rate is higher than the initial individual rate it means a definite discrimination against the corporate form, while the converse is true if the corporation is exempted or bears a rate lower than the individual rate. The effort should be to deal with both forms of enterprise on as nearly an equal tax basis as possible.

A Realistic Report

The report, taken as a whole, prepared by a committee balanced as between those with academic background, those with experience in the Treasury, and those in the accounting profession and in business who in their daily work are constantly seeing the effects of taxation upon business decisions and upon enterprise, gives a realistic and thorough-going analysis of the tax problem that is needed at this crucial time.

Its basic philosophy as to the much discussed "goal of full employment" is well summarized in the following paragraph:

> The most wholesome situation exists in the economy when a large national income is the fruit of a large volume of private production. The primary concern of all should be the maintenance of the conditions most favorable to ample production rather than provision of jobs. When this primary objective is reasonably accomplished, reasonably full employment will generally follow as a natural consequence. Where, on the other hand, full employment is made the primary goal, especially when implemented by creation of purchasing power through government action, the desired result may be secured, but it would be at best an artificial and unstable condition, and it would be at the expense of impaired production of the goods and services which satisfy human wants and whose maximum production is the real purpose of all economic activity.

Situation in the Philippines

The problem of rehabilitation and reconstruction in the Philippines becomes more critical with every day of delay in working out adequate remedial measures. People returning to this country tell a story of devastation and disorganization that is almost unbelievable. Manila and many other principal cities lie partly or wholly in ruins. Of the chief industries, much of the sugar milling equipment has been destroyed, the cocoanut oil mills even worse hit, and the gold mines stripped of essential machinery. Lesser industries have been similarly affected. The Japanese not only shelled and set fire to industrial and commercial establishments, public buildings, and homes; they also stole or destroyed automobiles, railroad equipment, farm implements, and work animals. While there have been some repairs to transportation facilities, the greater part of the Islands is still crippled by transport deficiencies.

Some hemp is available for export because of the Japanese interest in maintaining production, and some copra is also being sent to this country for processing into oil pending the reestablishment of Philippine milling facilities. Considerable quantities of tobacco are believed to have been accumulated in northern Luzon, but no substantial amount of sugar will be available for export until 1947 at the earliest.

Besides inflicting physical damage, the Japanese flooded the country with occupation currency — pure fiat money which declined in value and rapidly became worthless with the ebb of their military fortunes. Insurance companies and banks found their portfolios filling up with worthless assets. Debtors "liquidated" their obligations in this depreciated paper. Speculators made fortunes, while solid investors were ruined. The effect has been utterly demoralizing.

Even the "good" money in the Philippines is creating a problem in view of acute shortage of goods. With American military expenditures in the Islands lifting the present circulation of legitimate pesos to around 900 million, or four times the prewar level, an enormous inflation is under way, and will progress until sufficient consumers' goods become available either from local production or from imports.

Finally, there is the straitened position of the Philippine Treasury, reflecting the generally chaotic conditions in the country. The Government is understood to have no considerable free cash balance, and in the general state of confusion faces grave difficulty in imposing and carrying out any adequate system of taxation.

What Action Is Needed

From the foregoing review both the urgency and the general nature of the required course of action would seem to be reasonably clear. What we are having to deal with, as promptly as possible, is a complicated problem of both relief and of trade involving —

1. The question of compensation to the Philippines for the heavy losses forced upon them by the war.

2. Finding an answer to the shipping shortage which restricts the stream of consumers' goods and industrial equipment to the Philippines at a time when they are sorely needed.

3. Finding a sound and helpful solution of the vexing problems growing out of the Japanese currency issues.

4. Working out a formula for trade relationships with the United States which will encourage incentive and permit reconstruction to go forward with assurance of some assistance in the difficult task of adjusting the Philippine economy to independence after July 4, 1946, with its implication of ultimate status outside our tariff wall.

Unfortunately, very little progress has been made in these directions. In December, 1941, following Pearl Harbor, President Roosevelt and Secretary of Commerce Jesse Jones proclaimed publicly the intention to protect property-owners in respect of war damage whether in the Continental United States or in Insular Possessions. This promise was inplemented

by legislation in the Spring of 1942 setting up the War Damage Corporation, but the Islands were excluded from protection after July 1, 1942 on the ground that would-be insurers were unable to remit and that special treatment will have to be devised after the war. As a result there has been no provision to cover such losses after that date, since when most of the damage occurred.

There are at present two bills in the Senate, one introduced by Senator Tydings and the other by Senator Taft, dealing with Philippine losses not covered by existing legislation, but neither has emerged from committee and the former imposes a ceiling of $100 million which is far from adequate and would impose delays owing to the necessity of examining every claim and then prorating the ceiling amount. Meanwhile, businesses and industries in the Islands are stopped on dead center to the extent that the war robbed them of capital which cannot yet be replaced.

Neither of these bills, it will be noted, provides for any assistance to the Philippine Treasury in taking care of the heavy deficits inevitable during the reconstruction period.

As regards shipping, arrangements made for facilities approximating 30,000 tons per month during July, August, and September have provided for a bare trickle of necessities such as textiles, drugs, and foods, with little space for motor transport, building materials, and heavy machinery. It is hoped that for the last quarter of 1945 the tonnage may be doubled, but even so the facilities will be inadequate and additional allocations of shipping are badly needed.

On the question of Japanese issued pesos, the Philippine Government has failed thus far to find any satisfactory solution. Legislation that would give full value to all payments made in these pesos obviously would operate to the benefit of debtors, but would be grossly unfair and injurious to creditors, especially those who were unrepresented in the Philippines during the war. The problem is undoubtedly a difficult one, and the tendency is to try to reach a settlement which would constitute some sort of compromise, perhaps by assigning to the Japanese currency payments some value based upon the exchange relationship between the legitimate peso and the Japanese issue when the payments were made. This question should be settled promptly, for people must know where they stand. Business will be unable to go ahead vigorously or people contract new obligations until the status of present assets and liabilities is made known.

In the background of all these questions lies the problem of trade relationships with the United States. Even businesses and industries which have new capital to put in are being inhibited by the failure of the two Governments to find a solution of the question whether the Philippines are to enjoy preferential treatment in their trade with this country or to stand outside our tariff when they attain independence as they seem destined to do next July. Our March Bank Letter discussed the importance of this question to business enterprises dealing in imports and exports. A pending bill by Senator Tydings proposes to extend preferential tariff arrangements over the period to 1967, but contemplates yearly diminution of the preferential on a scale which would make it doubtful whether capital would go to work again in the Islands.

The problem is to find some compromise that will permit investors to amortize their costs. While the immediate need is to get recovery going with all possible speed, over the long term the effort should be to encourage development along lines which will promote the economic independence that is the logical concomitant of political independence.

Responsibility of the U. S.

In discussing the Philippine Islands, we are dealing with American territory. We have this year authorized immense amounts for the relief of numerous foreign countries and there is a great deal of talk about fulfilling our responsibilities to the whole world. Meanwhile hardly more than a token beginning has been made in aid of the Philippine people who are politically our own folk. Our Government and public opinion in this country recognize a special responsibility in connection with the Philippines, not alone because of the close political ties, but also because of the loyalty, heroic resistance, and sacrifices of the Philippine nation during the war. It is time, however, that we did something about it.

The recent appointment and Senate confirmation of the Honorable Paul V. McNutt as High Commissioner of the Philippines is evidence of the importance which our Government attaches to the Philippine problem, and is a hopeful augury that this problem will receive early attention. Mr. McNutt brings to this office experience as High Commissioner, in the years 1937 to 1939.

What we do in the Philippines is important not only to our own sense of moral responsibility and justice, but will affect our standing and prestige in the Orient. Whatever we do needs to be done quickly, for the situation has reached a point of crisis.

THE NATIONAL CITY BANK OF NEW YORK

***Head Office:* 55 Wall Street, New York**

Condensed Statement of Condition as of September 30, 1945

Including Domestic and Foreign Branches

ASSETS

Cash and Due from Banks and Bankers		$ 893,285,809.73
United States Government Obligations (Direct or Fully Guaranteed)		2,323,565,990.89
Obligations of Other Federal Agencies		34,568,891.16
State and Municipal Securities		165,903,531.63
Other Securities		98,181,066.47
Loans, Discounts, and Bankers' Acceptances		1,016,817,135.68
Real Estate Loans and Securities		6,036,851.66
Customers' Liability for Acceptances		6,656,464.75
Stock in Federal Reserve Bank		6,000,000.00
Ownership of International Banking Corporation		7,000,000.00
Bank Premises		30,224,729.38
Other Assets		2,901,561.85
Total		$4,591,142,033.20

LIABILITIES

Deposits		$4,298,169,026.41
(Includes U. S. War Loan Deposit $495,689,737.64)		
Liability on Acceptances and Bills	$11,728,880.94	
Less: Own Acceptances in Portfolio	4,332,283.29	7,396,597.65
Items in Transit with Branches		15,547,338.15
Reserves for:		
Unearned Discount and Other Unearned Income		1,846,684.41
Interest, Taxes, Other Accrued Expenses, etc.		27,974,881.22
Dividend		2,015,000.00
Capital	$77,500,000.00	
Surplus	122,500,000.00	
Undivided Profits	38,192,505.36	238,192,505.36
Total		$4,591,142,033.20

Figures of foreign branches are included as of September 25, 1945, except those of branches in the Far East possession of which we have not recovered. For these latter the figures are prior to enemy occupation but less reserves.

$697,088,011.50 of United States Government Obligations and $8,626,861.00 of other assets are deposited to secure $626,255,535.81 of Public and Trust Deposits and for other purposes required or permitted by law.

(Member Federal Deposit Insurance Corporation)

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CITY BANK FARMERS TRUST COMPANY

***Head Office:* 22 William Street, New York**

Condensed Statement of Condition as of September 30, 1945

ASSETS

Cash and Due from Banks		$ 31,079,227.60
United States Government Obligations (Direct or Fully Guaranteed)		161,542,912.67
Other Securities		593,903.25
Loans and Advances		981,690.00
Real Estate Loans and Securities		5,372,823.13
Stock in Federal Reserve Bank		600,000.00
Bank Premises		3,366,002.25
Other Real Estate		114,090.95
Other Assets		2,132,286.43
Total		$205,782,936.28

LIABILITIES

Deposits		$174,380,542.81
(Includes U. S. War Loan Deposit $42,518,123.90)		
Reserves		4,260,071.66
Capital	$10,000,000.00	
Surplus	10,000,000.00	
Undivided Profits	7,142,321.81	27,142,321.81
Total		$205,782,936.28

$79,607,467.26 of United States Government Obligations are deposited to secure the United States War Loan Deposit and for other purposes required or permitted by law.

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